Washington State Tax Structure Study
Findings on Stability/Volatility

Revenue volatility is a function of business cycles and our tax structure's response to those cycles.

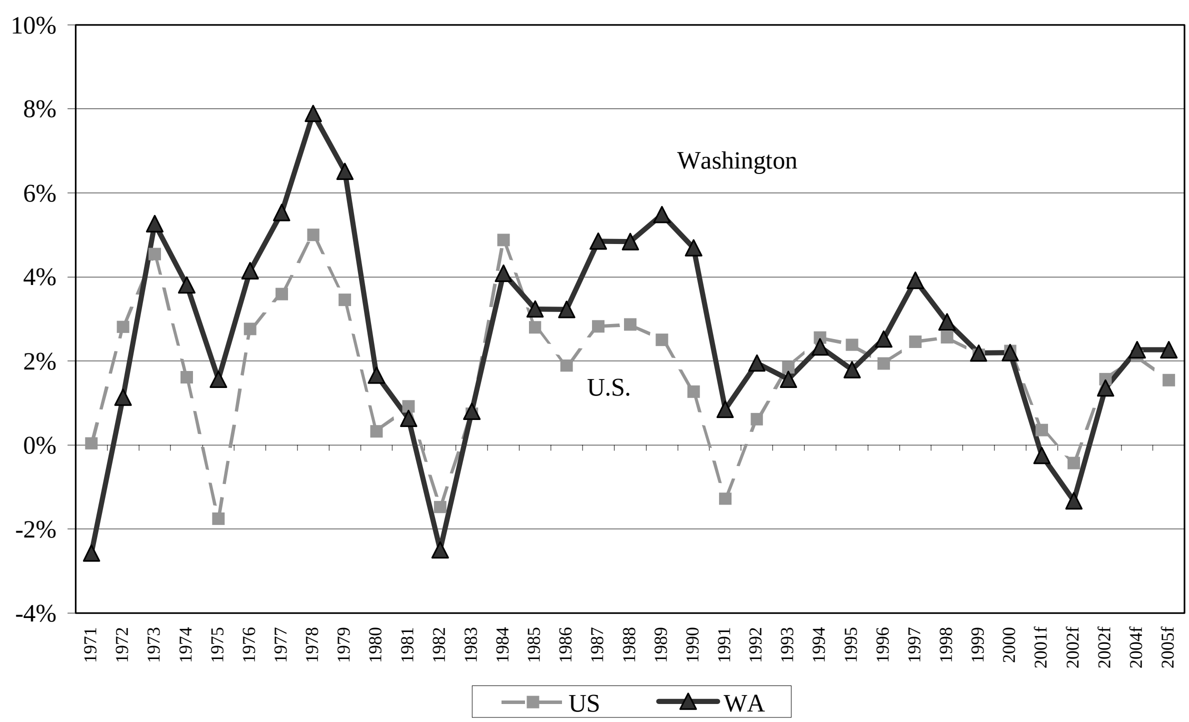
Business Cycles

Business cycles contribute to revenue instability in Washington and in all states.

States go through business cycles at different times. However, Washington's economy tends to follow the timing and magnitude of change in the U.S. economy more closely than most other states.

Washington's business cycles are less volatile than they used to be. Over the two decades from 1971 to 1990, Washington business cycle, as measured by the annual change in non-agricultural employment, varied more than twice as much as the U.S. business cycle. However, in the last decade, Washington's business cycle has been less volatile than the U.S. business cycle. The situation is expected to be reversed in the forecast period from 2001 through 2005 when Washington's year-to-year change in employment is expected to be more volatile than the U.S. average change in employment.

Annual Non-agricultural Employment Growth, WA and US



Tax Structure Response to Business Cycles

(Please *note: The following paragraph ranking taxes in order of volatility will be completed after Neil Bruce and DOR economists meet to discuss the formulas used in the analysis.)*

All of Washington's taxes are volatile. Some of Washington's taxes are more volatile than others. Taxes ranked in order of volatility with respect to personal income are as follows (1.0 = tax tracks with the business cycle, #1 = most volatile):

- Public utility taxes (x)
- Business and occupation taxes (x)
- Property taxes (x)
- Sales & use taxes (x)
- All taxes combined (x)

When taxes are volatile, excess revenues are generated in peak economic periods and the reverse is true in economic downturns. This is magnified when volatility is greater than the volatility of the business cycle.

Volatile taxes would be less of a problem to the extent a state is able and/or willing to:

1. Save excess revenues to spend during downturns.
2. Raise taxes during bad times and lower them during good times.
3. Lower spending during bad times.

With respect to spending during good and bad times, Washington State's expenditures over the last 20 years have been very stable despite economic fluctuations[1] which means they don't seem to adjust to changes in the business cycle.

Excess revenues create the impression that citizens have been overcharged for government services. Periods of excess revenues, even of a short-term duration, have historically enabled tax cuts to be made, often of a permanent nature. Permanent tax cuts exacerbate the problem of a volatile tax structure when the economy is in a downturn.

The following are possible policy choices to increase the overall stability of our tax structure:

1. Emergency reserve funds or budget stabilization accounts that can more effectively save revenues during good times for use during downturns,
2. Tax reductions during good times that don't permanently reduce the stability of the tax system,
3. Broader-based taxes,
4. A more "diversified portfolio" of taxes.

[1] Dye and McGuire, 1999